ACCT 101 – Chapter 4
Fundamentals of Accounting I
Accounting for Merchandising Operations
Prof. Johnson

A look back: Chapters 1 – 3 reviewed the accounting cycle for a service oriented firm. We also learned about the corporate form of organization. In this chapter, we learn about accounting for merchandisers or companies who buy and sell merchandise in the same form. You studied much of this at the end of ACCT 100.

A merchandiser buys and sells goods. Some merchandisers are wholesalers that sell to other companies and some are retailers who sell directly to the consumer.

The income statements are different:
A quick glance at income statements: An income statement shows whether a company was profitable or not using accrual basis accounting. For a service firm, we use a single step income statement. For a merchandising firm, it gets a little more complicated. We use what's called a multi-step income statement. Here's a brief "skeleton format" for each type of company:

A Service Firm

ABC Service Company
Income Statement
For the year ended 12-31-XX

Revenues:

Expenses:

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Net Income
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A Merchandiser

ABC Store
Income Statement
For the year ended 12-31-XX

Net Sales

- Cost of Goods Sold

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Gross Profit

- Operating Expenses

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Net Income
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Merchandising Issues

- The largest source of revenue for a merchandiser is sales. Usually the largest expense for a merchandiser is cost of goods sold. (This can also be called cost of sales.) The

difference between the net sales computation and cost of goods sold is gross profit, which is also called the gross margin.

- On the balance sheet of a merchandiser is the Merchandise Inventory account. It represents the stock of goods on hand that are intended to be sold.

- There are two types of inventory systems; the perpetual inventory system which keeps a record of all of the ins and outs in the inventory account and the periodic inventory system which only updates the inventory account at the end of the period. In this chapter, we will focus on a perpetual inventory system. Because technology has become so inexpensive and widely available, most companies have turned to a perpetual system. This means that the merchandise inventory account is updated for every purchase and decreased for every sale. Returns also affect the account.

Review of some "merchandising" accounts.

Sales - This account is a revenue account that records the sales of merchandise. Because it is a revenue account, it has a normal credit balance. It goes on the income statement

Sales returns and allowances This account is a contra-revenue account that tracks the physical returns or allowances granted to customers usually due to defective merchandise. Because it's a contra-revenue account, it has a debit balance and is normally debited when items are returned. On the income statement, it reduces the amount of sales to compute the Net Sales figure.

Sales discounts This account is also a contra-revenue account. It tracks the amount of discounts that customers take due to quick payments. Because it's also a contra- revenue account, it also is debited at the time discounts are taken. On the income statement, it reduces the amount of sales to compute the Net Sales figure. (Don't get this confused with purchases discounts which decrease the inventory account or with "Trade discounts" which offer a percentage off the catalog price.)

Cost of Merchandise Sold (also referred to as Cost of Goods Sold) - At the time of the sale, this account is debited for the cost of the goods that were sold. This is a major expense account, and usually represents the largest expense of a merchandiser. (This account is also adjusted for inventory shrinkage, which will be discussed later.)

Merchandise Inventory. This is a Balance Sheet account. It's an asset. Under a perpetual system, it is continuously updated. It is increased for purchases (and returns from customers) and decreased for sales. (Other items also affect this account like freight costs and discounts taken for prompt payments.)

Transportation In – Freight costs on merchandise shipped FOB shipping. This account is included in the cost of goods sold calculation.

Delivery Expense – Freight costs on merchandise shipped FOB Destination where the seller is responsible for the costs. This is an expense account and is listed under selling expenses.

Typical Inventory Transactions – The Buying Side -- What happens when you….?

Buy merchandise:

Dr. Merchandise Inventory

Cr. Cash or Accounts Payable

Take an early payment discount offered when purchased on account?

Dr. A/P

Cr. Cash

Cr. Merchandise Inventory (for amount of discount.)

Return merchandise that was defective to the vendor?

Dr. A/P

Cr. Merchandise Inventory

Other Issues with purchasing inventory:

- Freight terms are important. FOB or Free on Board determines who pays for transportation and when title passes.
- **FOB Shipping Point** – most common. The goods are the buyers as soon as it leaves the shipper's dock. Buyer pays freight. Buyer assumes risk of loss. If terms are FOB shipping, then the buyer charges the shipping costs to the merchandise inventory account.
- **FOB Destination** – not as common. The title stays with the seller until the goods are delivered to the buyer. Seller pays shipping and bears risk of loss. If terms are FOB Destination then the seller uses Delivery Expense or Transportation out to record the cost.
- Discounts for prompt payment cannot be taken on freight.
- Practice calculating amounts due.

The Sales Side of the House

Sales of Merchandise: Must record two entries… the revenue from the sale and the cost of the goods sold. Assume that a company sold goods that had cost $700 for $1,000 on account.

Dr. A/R

Cr. Sales

Dr. COGS

Cr. Merchandise Inventory

Discounts taken by customers for prompt payment:

Dr. Cash

Dr. Sales Discounts

Cr. A/R

Sales returns made by customers. Must again record two entries.. the return and the reduction of revenue, and the reversal of the COGS JE:

Dr. Sales returns and Allowances

Cr. A/R

Dr. Merchandise Inventory

Cr. COGS

The adjusting entry for Shrinkage:

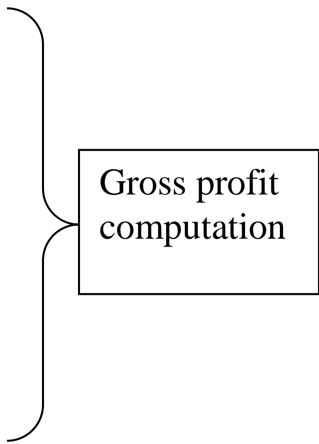
Dr. COGS

Cr. Merchandise Inventory

Closing Entries – You learned these at the end of ACCT 100.

- Why? To close out nominal accounts or temporary accounts to get them ready for the next period and to transfer net income and dividends to retained earnings.
- Which Accounts: Revenues, Expenses, Income Summary, and Dividends
- When? One time at the end of the accounting Period
- How? Closing is a game of opposites. See page 165 for a review of the closing process

The Multi Step Income Statement – Study the format in book



Revenue from Sales

  Sales

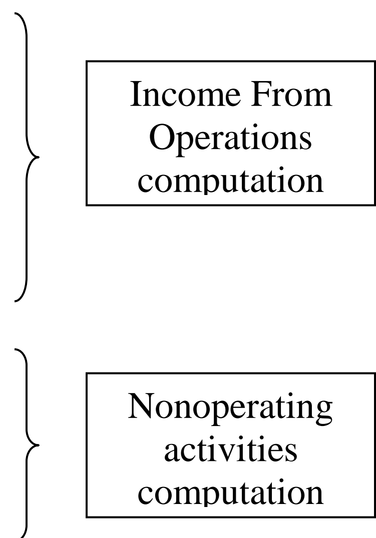
  Less Sales Discounts

  Less Sales Returns and Allowances

    Net Sales

Cost of Goods Sold

Gross Profit



Operating Expenses:

  Selling Expenses

  General and Administrative Expenses

    Total Operating Expenses

Income from Operations

Add: Other Revenues

Less: Other Expenses

Net Income

Nonoperating activities computation

Ratio Analysis

Acid Test = Cash and equivalents + Short Term Investments + A/R
Current Liabilities

Measure of ability to pay current obligations. Uses the most liquid assets. It's also known as the quick ratio.

Gross Margin Ratio = Net Sales - COGS (equivalent to Gross Profit)
Net Sales

Used to compare to benchmarks, in trend analysis, and to compare to competitors.